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August 25, 2006

Mr. Russell Read
Chief Investment Officer
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Domestic Equity Contract Renewal Recommendation¹

Dear Russell,

You requested Wilshire's opinion with respect to Staff's recommendation pertaining to the annual review and renewal of the contracts of the domestic equity managers. Wilshire concurs with Staff's recommendations, though we are closely watching two managers.

Discussion

During fiscal year 2005/2006, the domestic equity external manager program slightly underperformed its benchmark, lagging by 54 basis points. Essentially all of the underperformance occurred during the first half of calendar year 2006. 2006 has been a difficult year for many active managers as market leadership has shifted from value to growth and back again. Additionally, volatility in the market (as measured by the VIX index), which had been at very low levels, spiked in May causing turbulence while the equity markets fell several percentage points.

During the fiscal year, Staff continued to make improvements to the active domestic equity manager program as several underperforming managers resigned and additional enhanced index managers were funded. In addition, although not reflected in the fiscal year returns, Staff has recently completed a domestic large cap growth search and is in the process of conducting a short extension, or 130/30, search.

¹ Wilshire's Code of Conduct requires us to disclose which of the above firms are clients of Wilshire's Analytics Services Division and as such pay Wilshire a fee for the licensing of analytical software used in investment management. Wilshire's consulting division has no business relationship with them. This disclosure has been delivered under separate cover.

Domestic Equity Contract Renewal Recommendation

August 24, 2006

Page 2

The current stable of four active external managers has outperformed their respective benchmarks since inception, although recent performance has been mixed. We are closely watching two managers. Therefore, we support the annual contract renewal recommendation. Staff has the authority to terminate managers who do not perform as expected, and they have used that authority when necessary and appropriate. The renewal of these contracts does not in any way preclude Staff from exercising the authority to terminate any manager who ceases to perform as expected subsequent to contract renewal.

The two managers we are closely watching are AllianceBernstein and Pzena. While we believe that no action should be taken at this time, we will continue to closely monitor these managers in the near future. Below are discussions of each of the domestic equity external managers.

AllianceBernstein

AllianceBernstein utilizes a bottom-up approach for security selection that emphasizes the present value of each company's future cash flow. Using the cash flow analysis conducted by their analysts to calculate the present value of a company's future cash flows, AllianceBernstein compares the present value to the current price of the stock to find those companies that have the highest expected return. The strategy results in a portfolio that Wilshire considers "relative value" as opposed to "deep value." This relative value bias is also evidenced by the fact that AllianceBernstein optimizes its holdings against the S&P 500, a core benchmark, rather than a typical value benchmark. This relative value bias has been a headwind for AllianceBernstein versus some of its deep value peers.

Although the portfolio has underperformed in each of the last four fiscal years, since the account inception date the strategy has outperformed by 285 basis points on an annualized basis. Wilshire will work with Staff to closely monitor this manager over the next few periods.

Atlantic Asset Management

Atlantic manages an enhanced index portfolio that combines a short term bond portfolio with an S&P 500 futures overlay in an effort to outperform the index. This strategy is called a "synthetic" enhanced index strategy. For Atlantic, or any manager pursuing such a strategy, to be successful the short term bond portfolio must earn returns in excess of LIBOR (the financing rate embedded in the price of the futures contract). Managers generally look to add value by actively managing the duration of the portfolio and including "spread" sectors of the bond market – i.e., corporate bonds, mortgages, etc.

Atlantic's track record for CalPERS is slightly less than two years and the firm has underperformed modestly (by 119 basis points) during that time period. This was a particularly difficult period for all synthetic enhanced index managers as the Federal Reserve increased rates 17 times and the yield curve flattened and at times was even inverted. The increased interest rates have raised the LIBOR hurdle and the flattening of the yield curve has decreased the profitability of extending the duration of the portfolio.

Barclays Global Investors (BGI)

BGI uses a quantitatively driven, fundamental factor based enhanced index strategy. BGI requires that every factor in the model be grounded in economic logic, which prevents the firm from data mining historical returns for factors to be included. The risk factors of the portfolio (beta, size, style, sector weights, etc.) are all tightly controlled so that the portfolio should experience low tracking error.

BGI has only managed this portfolio for CalPERS for nine months and has outperformed by 308 basis points. Since sector weights are tightly controlled, stock selection has largely driven the returns.

The Boston Company

The Boston Company utilizes a value approach in managing this portfolio. The approach is based on fundamental analysis of individual companies. Internal research comprises approximately 90% of the total research effort. The Boston Company uses BARRA and Northfield to examine the risk profile of the portfolio on a weekly basis.

The Boston Company portfolio was funded in 1998 and has added 92 basis points of return (annualized) since inception. The portfolio has outperformed its benchmark in each of the past four fiscal years. This outperformance has been driven by strong stock selection.

Franklin Portfolio Associates

Franklin Portfolio Associates manages an enhanced index portfolio for CalPERS. The process is based on a bottom-up approach to selecting securities using sophisticated quantitative models. The models include seven themes: three are value oriented, three are growth oriented and one is a management signal. The firm uses a BARRA risk model and optimizer to construct portfolios that will have low tracking error to the benchmark.

Franklin Portfolio Associates was funded in 2004 and has added 62 basis points of performance (annualized) since inception. The portfolio outperformed in FY 2006 by 108 basis points.

Geewax, Terker & Co.

Geewax is an active growth equity manager that is focused on identifying and excluding stocks that are likely to underperform, rather than those that are likely to outperform. Individual security weights are determined by each stock's liquidity. Geewax has no tracking error or beta constraints, but views its process of identifying and excluding companies likely to underperform as a way to control risk.

Geewax was funded in 1998 and has added 29 basis points of return (annualized) since inception. The portfolio has outperformed in each of the past two fiscal years. The portfolio benefited from particularly strong stock selection in the first quarter of 2006 with stock picks in the Industrials and Information Technology sectors adding 320 basis points of return.

Goldman Sachs Asset Management

Goldman Sachs Asset Management (GSAM) manages a small cap enhanced index portfolio for CalPERS. The investment process is a bottom-up approach that forecasts alpha signals based on a variety of factors applied across industries. Factors are selected based on intuitive appeal and economic logic, statistical significance, and the ability to add to returns in a variety of market environments. GSAM uses a proprietary risk platform to help identify stocks with a heightened risk of financial distress – those stocks are subsequently avoided. Risks at the portfolio level are also controlled using a proprietary model for optimization and risk factor modeling.

The GSAM portfolio was funded in 2005 and has underperformed slightly in its brief history (104 basis points). Returns were hampered by stock selection in 1Q06 as Health Care and Information Technology stocks detracted from returns. Wilshire believes that GSAM's process is sound and the underperformance of the portfolio is an anomaly given the short time period since inception. Long term, we believe that the process will add value.

INTECH

INTECH uses mathematical models to manage this enhanced index portfolio. INTECH focuses on the volatility of stocks and the covariance of a stock's return with other stocks in the market. The firm does not use fundamental research of any kind, other than a very simple liquidity and bankruptcy screen. The portfolio's returns are driven by what they believe is a more efficient weighting of stocks in the index based on volatility and correlation and frequent rebalancing to this target weight. The firm rebalances the portfolio every six business days.

INTECH was funded in 2004 and has outperformed by 114 basis points (annualized) since inception. The portfolio slightly underperformed in FY 2006 as volatility appears to have experienced a regime change during the second quarter of calendar year 2006. Wilshire does not expect that the regime change from lower volatility to higher volatility will impede the portfolio's performance going forward.

Pzena

Pzena manages an all-cap value portfolio for CalPERS. The firm uses a bottom-up approach to security selection and runs a fairly concentrated portfolio, which has ranged between 35 and 41 stocks since inception. Pzena's approach is deep value and the product focuses on the "cheapest" quintile of a 1,500 stock universe. Pzena seeks out-of-favor companies where the firm feels there is a disconnect between the stock price and the company's normalized earnings.

Pzena was funded in 2000 and has outperformed by 438 basis points (annualized) since inception. Pzena has underperformed in each of the last two fiscal years and both stock selection and sector selection have played a role in the underperformance. Recently, Pzena's stock selection cost the portfolio 335 basis points during the first quarter of calendar year 2006. Selection was particularly weak in Information Technology (not a traditional value sector) and in Financials. Michael Schlachter conducted an on-site review of this manager in July 2006. Wilshire will work with Staff to closely monitor this manager over the next few periods.

Quantitative Management Associates

QMA manages an enhanced index portfolio for CalPERS. Different factors are examined for different types of companies: valuation metrics are used for slow growing companies and news-based metrics are used for fast growth companies. Risk controls are very tight with stock, industry and sector weights constrained to +/- 75 basis points of the index weights. An optimizer is used to maximize expected return, given the risk controls and a targeted 2% tracking error.

QMA was funded in 2004 and has outperformed by 114 basis points (annualized) since inception. QMA has benefited from both stock selection and sector selection.

Smith Breeden

Smith Breeden manages a synthetic enhanced index portfolio for CalPERS using short duration bonds and S&P 500 futures (see Atlantic Asset Management, above, for an explanation this type of investment process). Smith Breeden's approach is different from Atlantic's due to Smith Breeden's almost exclusive focus on spread product, especially within the mortgage area.

Smith Breeden was funded in 2004 and has underperformed by 7 basis points since inception. Like all other synthetic enhanced managers, Smith Breeden has faced a headwind of increasing rates and a flattening yield curve.

T. Rowe Price

T. Rowe Price (TRP) manages an enhanced index portfolio for CalPERS that is driven exclusively by the fundamental analysts that TRP employs. TRP has 35 different analysts covering various industries of the stock market. Each analyst selects which stocks the portfolio will own in the industries that they cover based on the analysts' evaluation of the company. TRP has a team that oversees the portfolio construction process and manages the sector weights and position limits to constrain the tracking error.

TRP was funded in 2006 and has slightly underperformed during its one-quarter tenure with CalPERS.

Western Asset Management

Western manages a synthetic enhanced index portfolio for CalPERS using short duration bonds and S&P 500 futures (see Atlantic Asset Management, above, for an explanation of this type of investment process). Western seeks to add value via security selection and the use of spread products, such as corporate bonds, mortgages, etc. The portfolio is broadly diversified with 100-140 securities in addition to the futures.

Western was funded in 2004 and has outperformed the index by 8 basis points (annualized) since inception. Like all synthetic enhanced index managers, Western has had to deal with the flattening of the yield curve and the recent increase in short term interest rates.

Conclusion

While Wilshire is closely watching two of the above mentioned managers, Wilshire concurs with Staff's recommendation to renew the contracts for all of the external active domestic equity managers and the external enhanced index domestic equity managers. CalPERS does have the right to terminate any of these managers with 30 days notice, if the need arises. Wilshire will continue to monitor these managers over the coming months.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,

A handwritten signature in dark ink, appearing to read "Dan Jiri", is located below the "Best regards," text.